No. 92-854

In The

Supreme Court of the United States

October Term, 1993

CENTRAL BANK OF DENVER, N.A.,

Petitioner,

v.

FIRST INTERSTATE BANK OF DENVER, N.A. and JACK K. NABER,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

BRIEF FOR PETITIONER

TUCKER K. TRAUTMAN
Counsel of Record for Petitioner
VAN AARON HUGHES
IRELAND, STAPLETON, PRYOR & PASCOE, P.C.
1675 Broadway, Suite 2600
Denver, Colorado 80202
Telephone: (303) 623-2700

Attorneys for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTIONS PRESENTED

1. Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

2. Whether recklessness satisfies the scienter requirement for aiding and abetting even where there is no breach of a duty to disclose or to act.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit is reported at 969 F.2d 891, and is reproduced in the Joint Appendix filed herewith ("J.A.") at page 183. The Order of the United States District Court for the District of Colorado is reproduced at J.A. 167.

JURISDICTION

The judgment of the court of appeals was entered on July 8, 1992. J.A. 183. Petition for Rehearing was denied on August 18, 1992. By order dated September 10, 1992, the court of appeals stayed its mandate until November 17, 1992. Petitioner filed its Petition for Writ of Certiorari on November 12, 1992. On June 7, 1993, this Court granted the petition

limited to Question 2 presented by the petition and in addition directed the parties to brief and argue whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) (1988).

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934: 15 U.S.C. § 78j. Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5: 17 C.F.R. § 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

In 1986, and again in 1988, the Colorado Springs-Stetson Hills Public Building Authority (the "Authority") issued tax-exempt municipal bonds to finance the acquisition of public improvements built by the developer of Stetson Hills, a planned residential and commercial community in Colorado Springs, Colorado. J.A. 126-37. Repayment of the bonds was to be made from special lien assessments against lot sales in Stetson Hills and was secured by land in the development which was required to have an appraised value of 160% of the outstanding principal and interest based on an appraisal performed by an MAI appraiser ("160% Test"). *Id.*

Petitioner Central Bank of Denver, N.A. ("Central Bank")[1] served as indenture trustee for both the 1986 and 1988 bond issues (the "1986 Bonds" and the "1988 Bonds," respectively). Central Bank's duties and responsibilities as trustee are set forth in respective Indentures of Trust for the two bond issues, the operative provisions of which are identical (collectively referred to as the "Indenture"). J.A. 138-51. The developer of Stetson Hills ("Developer") was required to provide Central Bank on an annual basis evidence satisfactory to the bank that the 160% Test was being met. J.A. 52-54. In October of 1987, Central Bank asked the Developer to provide by year-end an appraisal report performed by an MAI appraiser pursuant to the methodology specified in the Indenture in order to provide that evidence. J.A. 75-77.

In January of 1988, the Developer provided Central Bank with an updated appraisal performed by the same appraiser who had conducted the original appraisal of the property. J.A. 60-62, 71-74. Central Bank rejected the appraisal because it included not only the property securing the 1986 Bonds but also the property to be used to secure the proposed 1988 Bonds. Shortly thereafter, separate appraisals were furnished to Central Bank. *Id.* The values of property securing the 1986

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[1] Parent companies and subsidiaries of Central Bank are listed in its Petition for Writ of Certiorari at page ii.

Bonds remained essentially unchanged from those reflected in the original appraisal conducted in 1986. J.A. 63-64, 67-68.

At that same time, a controversy arose concerning the Developer's compliance with the 160% Test and the adequacy of the updated appraisal. In late January of 1988, Central Bank received a letter from the senior underwriter for the 1986 Bonds ("1986 Underwriter") stating that the 160% Test was probably not being met and raising concerns over reliance upon the original 1986 appraisal in light of declining property values and increasing foreclosures in Colorado Springs. J.A. 84-96. In response, the Developer corresponded with Central Bank, stating that an appraisal had recently been completed and that the claims of the 1986 Underwriter were "unfounded." J.A. 97-98. The lead underwriter for the proposed 1988 Bonds ("1988 Underwriter") also disputed the 1986 Underwriter's proposed method of calculating the 160% Test. J.A. 99-103.

In order to resolve the controversy, a meeting was convened in February of 1988 involving representatives of the Developer, Central Bank, and others. J.A. 65-67. The participants in the meeting discussed the appropriate methodology for calculating the 160% Test.[2] As a result of concerns over whether the 160% Test had been calculated correctly, the Developer agreed to contribute additional land to secure the 1986 Bonds. J.A. 69-70. In addition, in response to questions from Central Bank as to why the updated appraisal did not show a decline in land values from the original appraisal, a representative of the Developer stated that the values were substantially unchanged because $10 million worth of improvements had been added to the property since the original appraisal was done. J.A. 67-68.

In late February of 1988, after reviewing the updated appraisal, the 1986 Underwriter sent another letter to Central

[2] The methodology issue centered specifically on whether an interest component in the calculation should be simple interest or compounded. J.A. 101-02. A representative of Central Bank had confirmed at that time through her own calculations that the 160% Test may not have been met because of this problem. J.A. 65-66.

Bank stating that the appraiser was relying on old data not reflective of the current market. J.A. 106-10. As a result, Central Bank asked an in-house appraiser at the bank to review the appraisal.[3] J.A. 71-72. Upon review of the appraisal, the bank's appraiser also had questions as to the age of the comparable sales used and whether the methodology specified in the Indenture was followed. J.A. 64-65, 71-74. Due to his own time constraints, the in-house appraiser suggested that an independent, outside appraiser be hired to review the appraisal in order to follow up on these questions. J.A. 44-45.

On March 22, 1988, Central Bank sent a letter to the Developer instructing that an independent review of the appraisal be completed by a different appraiser to be selected subject to the bank's approval. The letter specified three reasons for the request. First, the age of the comparable sales data made it of questionable reliability, prompting Central Bank to inquire why more recent sales were not utilized. Second, the appraiser had confirmed that the discounting methods did not consider a bulk sale in a forced liquidation context, as specified in the Indenture. Third, the values determined by the appraiser appeared unjustifiably optimistic given the current economic conditions in the Colorado Springs market. J.A. 116-17.

After this letter was sent, the manager of Central Bank's corporate trust department took an active role in discussions concerning the 1986 Bonds. J.A. 68-69. On March 31, 1988, he met with representatives of the Developer and the 1988 Underwriter to discuss Central Bank's requirement of an independent review of the appraisal. J.A. 48-49, 52-54, 71-74. The Developer's representative confirmed that the Developer was willing to pledge an additional $2 million of land to the assessment lien for the 1986 Bonds. J.A. 49-52, 119. Concerning the appraisal, the Developer's representative informed Central Bank that the appraiser had, in fact, reviewed more recent comparable sales data, which were in

[3] The in-house appraiser worked in the bank's lending area and did not recall another situation where he was asked to review an appraisal relating to a bond issue in which Central Bank was acting as trustee. J.A. 44, 116-17.

conformance with the values in the appraisal, and had correctly followed the specified bulk sale discounting methodology. J.A. 73. The Developer's representative offered to obtain a letter from the appraiser confirming these facts. *Id.* In addition, he stated that the Developer did not want to have another appraisal performed at that time but would be willing to have a new appraisal completed by a different appraiser by year-end. J.A. 51-52. After the meeting, Central Bank's trust manager spoke with the bank's in-house appraiser who had confirmed with the Developer's appraiser that he properly followed the bulk sale methodology.[4] J.A. 45-47, 54-55.

On or about April 5, 1988, Central Bank's Corporate Trust Committee approved the Developer's proposal relating to the 1986 Bonds. J.A. 71-74. However, Central Bank imposed upon the Developer several conditions to its acceptance. Among these conditions were that the appraiser supplement his current appraisal with a letter pertaining to the bank's concerns on comparable sales data and the bulk sales methodology, that a new appraisal be performed by a specified appraiser by December 10, 1988, and that additional property valued at approximately $2 million be added to the assessment lien to bring the 1986 Bonds into compliance with the 160% Test. J.A. 120-23.

After resolving its concerns with respect to the 1986 Bonds, Central Bank turned its attention to the proposed 1988 Bonds. Central Bank's trust manager believed that the bond documents were not clear as to whether the appraisal used to support the 160% Test could include a "bring-down certificate" or updated appraisal as opposed to an entirely new appraisal. J.A. 52-55. Under the Indenture, Central Bank had the right to demand additional appraisals in connection with its responsibilities, but was not required to do so. J.A. 144-45. On May 13, 1988, Central Bank entered into a letter agreement with the Authority and the Developer which required that appraisals be provided to Central Bank on an annual basis

[4] The bank's appraiser apparently still believed that the appraisal "could be optimistic," but there is no evidence that he communicated this belief to Central Bank's trust manager. J.A. 44.

related to the 1986 Bonds and the proposed 1988 Bonds, with the first of such appraisals to commence by December 1, 1988, and to be completed within 90 days. J.A. 124-26. Central Bank's trust manager stated that the purpose of the letter agreement was to clarify what the bank would require in the future in order to avoid any confusion. J.A. 57-58.

The 1988 Bond issue closed on June 15 and 16, 1988, at which time Central Bank received the appraiser's certification stating, among other things, that other comparable sales were considered and did not materially alter the values in the report and that the bulk sale discounting methodology specified in the Indenture was followed. J.A. 71-74, 151-54. In carrying out its duties of authenticating and delivering the 1988 Bonds, Central Bank accepted the appraisal, the appraiser's certificate, and a certificate by the Authority and the Developer that the 160% Test had been met.[5] J.A. 71-74, 151-54.

When the Developer failed to complete the first annual appraisal as required by the May 13, 1988 letter agreement, Central Bank sent notices to bondholders informing them that the Authority was in technical default. J.A. 154-62. Subsequently, the Authority defaulted on monetary payments on the 1988 Bonds. J.A. 163-66.

After the monetary default, the Respondents, two holders of 1988 Bonds, brought an action against the Authority, the 1988 Underwriter, a junior underwriter on the bonds, a director of the Developer, and Central Bank. Respondents allege that the sale of the bonds was in violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992), promulgated thereunder.[6]

[5] The bank did not participate in the preparation of the disclosure documents relating to the 1988 Bonds. While drafts of the disclosure documents were provided to Central Bank, its representatives reviewed them only to assure that its name was properly stated, and none of its representatives attended drafting sessions concerning the disclosure documents. J.A. 71-74, 81-84, 111-15.

[6] The Authority, the underwriter defendants and the director of the Developer were all sued for alleged primary violations of § 10(b) and under secondary liability

Respondents claim that the 1988 Bonds were issued and marketed both through a fraudulently misleading disclosure document, which did not disclose the questions raised concerning the appraisal and the 160% Test in connection with the 1986 Bonds, and by means of a scheme to delay an independent review of the appraisal until six months after the 1988 Bonds were issued. Central Bank is alleged to have knowingly or recklessly aided and abetted the § 10(b) violation by its decision as trustee to postpone an independent review of the appraisal until after the issuance of the 1988 Bonds and by its failure to alert investors in the 1988 Bonds of the risks connected with the appraisal. J.A. 3-27.

The district court granted summary judgment for Central Bank, holding that the scienter requirement for aiding and abetting liability "may not be satisfied by showing recklessness absent an additional duty to disclose" and finding no genuine issue of material fact as to the bank's knowledge or a duty to disclose. J.A. 167-76. The court of appeals reversed and remanded, holding that aiding and abetting liability based upon recklessness could be established absent a duty to disclose when the defendant assists the primary violation by "affirmative action." The court agreed with the district court that Central Bank owed no disclosure duty to Respondents, and that it had complied with its duties under the Indenture. However, purporting to rely on *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478 (9th Cir. 1991), and *FDIC v. First Interstate Bank*, 885 F.2d 423 (8th Cir. 1989), the court held that recklessness was sufficient to impose liability, since Central Bank affirmatively agreed to delay the independent review of the appraisal.[7] Reviewing the evidence in the light most

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theories of conspiracy and aiding and abetting and, in the case of the director of the Developer, controlling person liability under section 20 of the Securities Exchange Act, 15 U.S.C. § 78t (1988). Central Bank was named only as an alleged aider and abettor of the primary violations of others. J.A. 3-27.

[7] The court of appeals noted that the district court order only dealt with plaintiffs' claims of affirmative acts by Central Bank and it construed a statement by plaintiffs in their reply brief on appeal as an abandonment of their claim that Central Bank improperly remained silent. J.A. 207 n.18.

favorable to plaintiffs, the court concluded that Central Bank's conduct could support a finding of extreme departure from the standards of ordinary care and thus constitute recklessness. In light of its disposition on the recklessness issue, the court did not reach the issue of the bank's knowledge of the alleged fraud. Finally, the court held that plaintiffs had raised a genuine issue of material fact on the substantial assistance element because the trier of fact could reasonably conclude that had Central Bank not agreed to delay the independent review of the appraisal, the inadequacy of the collateral would have been discovered and the bondholders' losses avoided. J.A. 183-213.

SUMMARY OF ARGUMENT

In 1971, an implied private right of action against primary violators of § 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") was recognized by this Court. Since then, the Court has twice reserved the question of whether there is a similar private right of action for aiding and abetting § 10(b) violations, and on several occasions has instructed that additional private rights under § 10(b) are to be implied only if it appears that Congress would have included the asserted right within § 10(b) had it considered the matter, and if the right is consistent with the language of § 10(b). By reversing the district court's grant of summary judgment in favor of Central Bank, the court of appeals has embraced an implied right of action for aiding and abetting which fails both these conditions. There is nothing to suggest that Congress would have chosen to include aiding and abetting liability within the private remedies under § 10(b). To the contrary, Congress' actions demonstrate that it deliberately omitted any private aiding and abetting right from the 1934 Act. Furthermore, in the absence of any duty to disclose or to act, aiding and abetting liability based only on recklessness is an impermissible departure from the language of § 10(b), which reaches only manipulative or deceptive conduct.

Every tool of statutory construction this Court has used with respect to implied rights of action under the securities

acts weighs heavily against implication of a private right of action for aiding and abetting a violation of § 10(b). The language of § 10(b) provides no support for any aiding and abetting theory. Rather, the language is directly at odds with the concept of aiding and abetting, which requires manipulative or deceptive conduct by the primary violator, not by the assisting defendant. Examination of analogous provisions of the 1934 Act further dispels any inference that Congress would have intended private aiding and abetting rights. Aiding and abetting language is conspicuously absent from provisions in the 1934 Act granting express private rights of action, particularly §§ 9 and 18, which the Court has described as most analogous to the implied § 10(b) private right. Congress has repeatedly incorporated aiding and abetting language into provisions creating criminal liability and granting civil enforcement powers to the Securities and Exchange Commission ("SEC"), yet has declined to add aiding and abetting to § 20 of the 1934 Act, the provision which creates express liability against controlling persons. By limiting derivative liability to controlling persons, Congress has manifested its intention not to institute derivative liability in private actions against aiders and abettors. It is evident that Congress knows how to create derivative liability, and specifically aiding and abetting liability, within the 1934 Act. It has chosen not to impose a private right of action against aiders and abettors.

Lower courts have nevertheless perpetuated the concept of an implied aiding and abetting right, despite the increasing criticism levied against it. This implied right was borrowed from tort law. However, this Court has since held that a private right of action under the securities laws cannot be implied based on tort principles, but instead must flow from the rigorous statutory construction analysis laid down by this Court.

Even if an adequate basis existed for an implied right of action against aiders and abettors under § 10(b), *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), makes clear that no liability may be imposed unless the defendant is guilty of conduct of a manipulative or deceptive nature. Central Bank

is not. As the court of appeals held, Central Bank owed Respondents no duty to disclose or to act. Central Bank exercised its discretion under the Indenture to ask the Developer for an independent review of its appraisal, when the bank was under no obligation to do so. After receiving assurances that the perceived problems with the appraisal were without merit, Central Bank again used its discretion in deciding to wait six months for a new appraisal. While this decision has since been second-guessed by Respondents, there is no suggestion in the record that Central Bank intended to deceive Respondents or even that the bank knew they were being deceived. The court of appeals made no such finding, holding only that Central Bank may have been reckless in agreeing to wait for the new appraisal. Because it deemed this an affirmative action, the court found recklessness a sufficient basis for aiding and abetting liability, improperly divorcing its scienter analysis from the requirement of manipulative or deceptive conduct.

The flaw in the approach of the court below stems from its failure to consider whether Central Bank owed any relevant duty to disclose or to act. As the majority of the courts of appeals have agreed, recklessness can be sufficient scienter for aiding and abetting a securities fraud, if ever, only where the defendant owed some duty to the plaintiff. It is reasonable to equate recklessness with deception only where the relationship between the defendant and plaintiff created an expectation by the plaintiff that the defendant would speak or act to protect the plaintiff's interest. If the defendant had no duty to speak or to act, it cannot have deceived the plaintiff without possessing either actual knowledge of the fraud committed by the primary violator or conscious intent to further the fraud.

The court of appeals abandoned this rule in favor of its new theory that recklessness is sufficient whenever the defendant takes an affirmative action which in some way assists the fraud. This view fails both on a conceptual level, because it ignores the requirement of deception by the defendant, and as a practical matter, because it focuses entirely on the tenuous and unworkable distinction between action and inaction. Given the potential damage the Tenth Circuit's new rule could

inflict on legitimate business entities that assist in securities transactions in full compliance with their state law duties, the Court should reverse the decision of the court of appeals and reinstate the district court's grant of summary judgment in favor of Central Bank.

ARGUMENT

I. THERE IS NO IMPLIED PRIVATE RIGHT OF ACTION FOR AIDING AND ABETTING VIOLATIONS OF SECTION 10(b) AND RULE 10b-5.

In recent decisions involving implied private rights of action under § 10(b),[8] this Court has "made no pretense that it was Congress' design to provide the remedy afforded." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S.Ct. 2773, 2780 (1991). Implied private rights under § 10(b) constitute "a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).[9] In determining the nature and extent of private rights, however, the Court continues to give as much deference as possible to Congressional policies. To that end, the Court's statutory construction analysis involves first an examination of the language of the relevant section at issue and then a review of comparable express remedial provisions in order "to infer now the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act." *Musick,*

[8] This case concerns the existence and scope of implied private rights of action for aiding and abetting violations of § 10(b) and Rule 10b-5. The SEC adopted Rule 10b-5 pursuant to the authority granted by § 10(b) and the scope of Rule 10b-5 cannot exceed that of § 10(b) itself. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977) ("the language of the statute must control the interpretation of the Rule"). For this reason, the discussion in Petitioner's brief shall be limited throughout to the availability of implied private rights of action under § 10(b).

[9] *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), first implied a private right of action under § 10(b). The right was recognized by this Court in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

Peeler & Garrett v. Employers Ins. of Wausau, 113 S.Ct. 2085, 2089-90 (1993). Applying this standard, it is evident that § 10(b) was intended to reach only defendants who themselves engage in manipulative or deceptive acts and not those who, by their action or inaction, assist such conduct by others. Likewise, the comparable sections of the 1934 Act previously used by this Court as a measure of Congress' hypothetical intent offer no hint that the 1934 Congress would have swept alleged aiders and abettors into the § 10(b) net. Rather, the Act reveals a clear Congressional intent to incorporate aiding and abetting only in very limited circumstances analogous to the theory's criminal law origins, and not to include it within the private derivative liability permitted by the Act.

A. An Implied Private Right Of Action For Aiding And Abetting Is Contrary To The Express Language Of Section 10(b).

The court of appeals imposed aiding and abetting liability against Central Bank without analyzing the basis for a private right of action for aiding and abetting under § 10(b).[10] Such a private right cannot withstand serious scrutiny under the standards identified by this Court. An aiding and abetting right is not provided by the statute, nor is such a right consistent with its express language.[11]

[10] Neither party raised the issue below because the Tenth Circuit, like many other circuits, had previously upheld private aiding and abetting claims under § 10(b) without analysis. *See Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982 (10th Cir. 1992); Section I.C., *infra*.

[11] This Court has twice considered and reserved judgment on whether the application of aiding and abetting to § 10(b) in private actions is justified by the language and intent of the 1934 Act. *Ernst & Ernst*, 425 U.S. at 191 n.7; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983). The courts of appeals have uniformly assumed the existence of a private right of action for aiding and abetting, deriving the theory from general tort law principles. *See* Section I.C., *infra*.

1. Section 10(b) Does Not Provide Liability For Aiding And Abetting.

This Court has had occasion in many recent cases to consider asserted implied rights under § 10(b) and related provisions of the securities laws. The focus in determining whether to recognize an implied right is how the 1934 Congress would have addressed the issue. *Musick*, 113 S.Ct. at 2089-90. The clearest indicator of the intentions of Congress is always the statute itself. "The question of the existence of a statutory cause of action is, of course, one of statutory construction." *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979) (citations omitted). The Court must therefore look first to the language chosen by Congress. *Ernst & Ernst*, 425 U.S. at 197 ("we turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself' ") (quoting *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring)).

Section 10(b) makes it "unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance. . . . " The language of § 10(b) is expressly limited to primary violators, the perpetrators of securities fraud. The statute creates only direct liability, not derivative liability based on the primary violations of others. *Musick*, 113 S.Ct. at 2090. No provision is made for aiding and abetting or other forms of secondary liability.

Nor does the legislative history provide any support for the belief that § 10(b) extends to aiders and abettors. The Court previously examined the sparse legislative history of § 10(b) in *Ernst & Ernst*, concluding that the provision was intended "to enable the Commission 'to deal with new manipulative [or cunning] devices.' " *Ernst & Ernst*, 425 U.S. at 203 (brackets in original) (quoting *Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran)). Thus, the legislative history reflects Congress' concern with parties who perpetrate some form of cunning device, and shows no intention to reach those who are merely negligent, as held in *Ernst & Ernst*, or those

who merely in some way assist another in committing a violation. The right of action asserted by Respondents simply has no basis in the underlying statute.

2. An Implied Private Right Of Action For Aiding And Abetting Is Inconsistent With The Language Of Section 10(b), Which Proscribes Only Manipulative Or Deceptive Conduct.

The failure of Congress to provide for aiding and abetting liability in § 10(b) is fatal to Respondents' claim because to imply such a cause of action would be inconsistent with the language that *is* included in the provision. Creation of an implied aiding and abetting right goes far beyond recognition of an implied private right against primary violators of § 10(b). The cause of action Respondents ask this Court to endorse would improperly allow private parties to seek damages under § 10(b) for actions which are not proscribed by that provision.

Section 10(b) does not make explicit provision for any private rights of action, yet this Court recognized an implied right against primary violators of the statute in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). However, while the statute is ambiguous as to the existence of a private right of action under § 10(b), it is not ambiguous as to who is a proper defendant in any such action, if recognized. A private right can lie, at most, against those who have violated the terms of the statute. It cannot extend to third parties who may simply have been of assistance to the primary violator.

In declining to recognize an implied private right of action under section 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1988), this Court explained the necessary basis for any implied right of action:

> It is true that in the past our cases have held that in certain circumstances a private right of action may be implied in a statute not expressly providing one. But in those cases finding such implied private remedies, the statute in question *at least prohibited*

certain conduct or created federal rights in favor of private parties.

Touche Ross, 442 U.S. at 569 (emphasis added) (citations omitted). Section 10(b) does prohibit certain conduct, namely, manipulative or deceptive devices or contrivances. Thus, courts may be justified in permitting a private right of action against defendants who engage in such manipulative or deceptive conduct. "However, under a strict aiding and abetting analysis, it is irrelevant whether an aider and abettor has engaged in a manipulative or deceptive practice within the meaning of section 10(b). What is relevant is whether the *primary violator* engaged in such a practice." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80, 88 (1981) (emphasis in original). Thus, aiding and abetting liability would permit private actions against defendants who are not themselves guilty of manipulative or deceptive conduct.

Aiding and abetting liability would therefore thwart the "manipulative or deceptive" standard which this Court has treated as crucial to any action under § 10(b). In *Ernst & Ernst v. Hochfelder*, the Court stressed this language, which it found inconsistent with a private right of action under § 10(b) based on negligent conduct by the defendant. The words "manipulative," "device," and "contrivance" in § 10(b) all refer to a particular type of fraudulent conduct and the phrase "[t]o use or employ" clearly requires fraudulent conduct by the defendant. 425 U.S. at 199 & n.20. The Court again invoked this language in refusing to allow a private right under § 10(b) by minority shareholders claiming a breach of fiduciary duty by the majority. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."). It is incompatible with the crucial language of § 10(b) to impose liability in a private action against a defendant who is not the party guilty of the fraudulent conduct proscribed by § 10(b).

This inherent incompatibility exists without regard to the level of scienter required for aiding and abetting liability. Whatever the degree of scienter, the aider and abettor is not

required to have engaged in manipulative or deceptive conduct, but merely to have substantially assisted such conduct. Each of the courts of appeals which has addressed the issue considers "substantial assistance" of a primary violation of § 10(b) an element of aiding and abetting liability, although there is little uniformity in the courts' application of the "substantial assistance" standard.[12] Because substantial assistance of a primary violation is not the conduct prohibited by the statute, courts are entirely without guidance as to who may be subjected to liability.[13] By refusing to extend an implied private right of action to alleged aiders and abettors of § 10(b) violations, the Court can eliminate the conceptual quagmire of the substantial assistance test while honoring the Congressional intent to require manipulative or deceptive conduct *by the defendant*.

B. An Implied Private Right Of Action For Aiding And Abetting Violations Of Section 10(b) Is Contrary To The Congressional Intent Embodied In The 1934 Act.

In ruling on an implied private right of action under the securities laws, the Court's "task is limited solely to determining

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[12] *See, e.g., Dirks v. SEC*, 681 F.2d 824, 844 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978); *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991), *cert. denied*, 112 S.Ct. 1475 (1992); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987), *cert. denied*, 483 U.S. 1006 (1987); *Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1009 (11th Cir. 1985). Substantial assistance of the primary violation is also necessary in the Seventh Circuit, but there the test has been greatly overshadowed by the further requirement that the aider and abettor meet all standards for primary liability except that the aider and abettor need not sell the securities. *See, e.g., Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96 (7th Cir. 1986). The Seventh Circuit is thus the only court of appeals which requires manipulative or deceptive conduct by the defendant to impose § 10(b) aiding and abetting liability.

[13] The amorphous standard of "substantial assistance" is reminiscent of the "substantial factor" test for determining who could be liable under § 12(1) of the 1933 Act rejected by this Court in *Pinter v. Dahl*, 486 U.S. 622 (1988).

whether Congress intended to create the private right of action asserted." *Touche Ross*, 442 U.S. at 568; *accord, Virginia Bankshares, Inc. v. Sandberg*, 111 S.Ct. 2749, 2763 (1991); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979). The relevant inquiry with respect to § 10(b) and Rule 10b-5 is "how Congress would have balanced the policy considerations" presented. *Lampf*, 111 S.Ct. at 2780. A review of the structure of the 1934 Act reveals Congress' intentions with respect to aiders and abettors – Congress expressly provided for aiding and abetting liability in disciplinary actions brought by the SEC, but conspicuously omitted any cause of action against aiders and abettors in the provisions creating private rights of action. Section 10(b), like the provisions of the 1934 Act which create express private rights of action, does not reach aiding and abetting.

1. Provisions In The 1934 Act Which Convey Express Private Rights Of Action Do Not Create Any Rights Against Aiders And Abettors.

While Congress did not contemplate a private right of action under § 10(b) in 1934, it did enact other provisions of the 1934 Act, as well as the Securities Act of 1933 (the "1933 Act"), which explicitly created private rights of action. In determining the extent of implied private rights of action under § 10(b), the Court has looked to these provisions, particularly §§ 9 and 18 of the 1934 Act, which it has deemed most analogous to § 10(b) in structure, purpose, and intent. Since Congress chose not to include express rights against aiders and abettors in those provisions, no implied right may lie against aiders and abettors under § 10(b).

In discerning the extent of implied private rights of action under a given statute, the inquiry is most easily resolved by looking to comparable express remedial provisions in the statute. *Lampf*, 111 S.Ct. at 2780. This Court has identified eight provisions of the 1933 and 1934 Acts which create express private rights of action, §§ 11, 12, and 15 of the 1933 Act, 15 U.S.C. §§ 77k, 77l, 77o (1988) and §§ 9, 16, 18, 20, and 20A of the 1934 Act, 15 U.S.C. §§ 78i, 78p, 78r, 78t, 78t-1 (1988). *Musick*, 113 S.Ct. at 2090-91. Not one of these creates a right of action against aiders and abettors.

Particularly significant among these provisions are §§ 9 and 18 of the 1934 Act. Sections 9 and 18, respectively, create private civil liability for effecting a manipulation of securities prices and for making misleading statements in filings with the SEC. In its recent decisions in *Lampf* and *Musick*, this Court relied upon these provisions in ruling on the scope of the implied private right of action under § 10(b). These two sections "target the precise dangers that are the focus of § 10(b)," *Lampf*, 111 S.Ct. at 2781, and "impose liability upon defendants who stand in a position most similar to 10b-5 defendants." *Musick*, 113 S.Ct. at 2090. Both § 9 and § 18 explicitly provide a statute of limitations of one year from discovery with a three year period of repose. 15 U.S.C. §§ 78i(e), 78r(c) (1988). The Court adopted this statute of limitations to implied rights of action under § 10(b) in *Lampf*. Both § 9 and § 18 explicitly provide defendants a right of contribution against parties who share joint responsibility for violation of the provisions. 15 U.S.C. §§ 78i(e), 78r(b) (1988). The Court therefore reasoned in *Musick* that the 1934 Congress would have granted a right of contribution to defendants in implied private 10(b) actions had it considered the question.

Section 9 and § 18 do not, however, provide any explicit rights of action against aiders and abettors.[14] Whereas an

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[14] Lower courts in three reported decisions arguably assumed with little or no discussion the existence of an implied private right of action against aiders and abettors under these provisions, but each case centered primarily on violations of other securities provisions, particularly § 10(b) and Rule 10b-5, and the courts simply lumped actions under §§ 9 or 18 together with the presumed implied private right against aiders and abettors under § 10(b). *See Sennott v. Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973) (finding insufficient evidence to support trial court's judgment against defendants for aiding and abetting securities fraud which violated § 10(b), Rule 10b-5, § 9(a)(4), and § 17(a) of the 1933 Act), *cert. denied*, 414 U.S. 926 (1973); *In re Investors Funding Corp of New York Sec. Litig.*, 523 F. Supp. 533 (S.D.N.Y. 1980) (dismissing claims for aiding and abetting violations of §§ 10(b) and 18); *In re Caesars Palace Sec. Litig.*, 360 F. Supp. 366, 386 (S.D.N.Y. 1973) (holding that § 18, like "the federal securities laws as a whole," permits aiding and abetting liability). Since it is the existence of such an implied right under § 10(b) which the Court must now decide, these opinions are of little assistance.

implied private right for contribution under § 10(b) was appropriate given that Congress had allowed contribution in the express remedies it created, under the same logic there can be no implied right of action under § 10(b) against aiders and abettors. The failure of Congress to create aiding and abetting liability where it imposed express private rights of action precludes a finding that a right against aiders and abettors is implied under § 10(b).

2. Congress Has Specified Which Provisions In The Securities Acts It Intended To Reach Aiders And Abettors.

In sharp contrast to the express private rights of action contained in the 1934 Act, which do not mention aiding and abetting, Congress has explicitly authorized criminal liability and disciplinary actions by the SEC based on aiding and abetting, while refusing to amend the 1934 Act to include private civil aiding and abetting remedies. Congress' use of aiding and abetting language only in enforcement provisions is entirely incompatible with judicial creation of an implied private right of action for aiding and abetting.

Congress long ago created general criminal liability for aiding and abetting criminal violations of federal law. *See* 18 U.S.C. § 2(a) (1988). This provision, which dates back to 1909, reaches aiders and abettors of criminal violations of the securities laws. Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 Alb. L. Rev. 637, 766 (1988); *see, e.g., United States v. Re*, 336 F.2d 306, 318 (2d Cir. 1964), *cert. denied*, 379 U.S. 904 (1964). Thus, from the time of its enactment, aiding and abetting criminal violations of the 1934 Act has always been a separate criminal offense.

Whereas Congress has always endorsed criminal aiding and abetting liability, it has declined to add aiding and abetting language to the 1934 Act's private civil liability provisions. In particular, a bill introduced in 1959 would have altered the caption of § 20 of the 1934 Act from "Liabilities of Controlling Persons" to "Liabilities of Controlling and Associated Persons," and made it "unlawful for any person to

aid, abet, counsel, command, induce or procure the violation of any provision of [the 1934 Act] or any rule or regulation thereunder by any other person." H.R. 2480, 86th Cong., 1st Sess. §§ 21, 22 (1959); S. 1179, 86th Cong., 1st Sess. §§ 21, 22 (1959). The SEC advocated this language arguing that aiders and abettors should be "culpable in administrative or injunction actions brought against them." *SEC Legislation: Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 86th Cong., 1st Sess., on S. 1178, S. 1179, S. 1180, S. 1181, and S. 1182*, 276 (1959) (hereinafter "*SEC Legislation Hearings*"). The Commission explained that the language would be applied in accordance with the criminal law theory of aiding and abetting, which requires that the defendant "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." *Id.* at 276 (quoting *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938) (L. Hand, J.)). The provision was apparently not contemplated as an endorsement of broad new private rights against aiders and abettors.

Nevertheless, the proposed addition of aiding and abetting language to § 20 prompted "industry fears that private litigants, not only the SEC, may find in this section a vehicle by which to sue aiders and abettors." *SEC Legislation Hearings* at 288, 370. The proposal was rejected despite the Commission's suggestion that the legislation could be revised to clarify that no private civil liability was intended. *Id.* Similar aiding and abetting measures also failed in 1957 and 1960. *See* S. 2545, 85th Cong., 1st Sess. § 19 (1957); S. 3770, 86th Cong., 2d Sess. § 20 (1960).

Congress' decision not to enact any of these proposals demonstrated its intention not to incorporate a private right of action against aiders and abettors into the 1934 Act. Indeed, this Court relied upon identical legislative history in determining Congressional intent in *Blue Chip Stamps*, 421 U.S. at 732-33. There the Court declined to expand the "purchase or sale" requirement of § 10(b) to allow a right of action to offerees of a stock offering. The Court observed that in 1957

and 1959 Congress considered legislation to include within § 10(b) "any attempt to purchase or sell" a security. This proposal appeared in the same bills which contained the aiding and abetting language discussed above. H.R. 2480, 86th Cong., 1st Sess. § 10 (1959); S. 1179, 86th Cong., 1st Sess. § 10 (1959). The SEC supported both the "attempt to purchase" and the aiding and abetting provisions but in both instances noted industry fears of the expansion of civil liabilities which could result. *See SEC Legislation Hearings* at 288, 368, 370. In *Blue Chip Stamps*, the court concluded that by not adopting the "attempt to purchase" language, Congress evidenced its intent not to dilute the "purchase or sale" requirement. 421 U.S. at 732-33. By the same token, Congress' failure to adopt the aiding and abetting provision in the same proposed legislation reveals its choice not to create private civil aiding and abetting liability.[15]

In contrast to its decision not to include aiding and abetting liability within § 20's civil remedies, Congress has expressly added aiding and abetting to several provisions governing SEC enforcement of the securities laws. The primary enforcement provision of the 1934 Act governing aiding and abetting is § 15(b), 15 U.S.C. § 78o(b) (1988). As amended, this section allows the SEC to censure or otherwise discipline any broker or dealer who:

> has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any

[15] Occasionally, where Congress has known of a particular judicial interpretation of a statute and has chosen to re-enact the statute without change, such action has been considered evidence of Congress' approval of the interpretation. *See, e.g., Lorillard v. Pons*, 434 U.S. 575, 580-81 (1978). However, Congressional inaction cannot be so viewed where it has specifically been asked to incorporate the interpretation into the legislation and has rejected such requests. *T.I.M.E. Inc. v. United States*, 359 U.S. 464, 477-78 (1959); *see also Touche Ross*, 442 U.S. at 571 ("implying a private right of action on the basis of congressional silence is a hazardous enterprise, at best . . . [especially] where, as here, the plain language of the provision weighs against implication of a private remedy"). Thus, Congress' choice not to add aiding and abetting language to the 1934 Act's civil provisions negates any possible contention that it has endorsed a private right of action against aiders and abettors.

> other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board.

15 U.S.C. § 78o(b)(4)(e) (1988). Congress incorporated this explicit aiding and abetting language into the SEC's disciplinary powers in 1964. Pub. L. No. 88-467, sec. 6(b), 78 Stat. 565, 571 (1964). This aiding and abetting language was added only to § 15, which concerns registration and regulation of brokers and dealers by the SEC and does not purport to create any private rights of action,[16] and was not added to § 10(b) or to any of the provisions of the 1934 Act creating private rights of action.

Several other provisions of the 1934 Act and related acts give the SEC or related regulatory bodies[17] further enforcement powers against aiders and abettors. Sections 15B and 15C of the 1934 Act, 15 U.S.C. §§ 78o-4, 78o-5 (1988), added in 1975 and 1986, respectively, empower the SEC to censure municipal or government securities brokers or dealers, or their associates, for violations of the provisions of § 15(b)(4)(E), which explicitly includes aiding and abetting. Under § 21B, 15 U.S.C. § 78u-2 (Supp. III 1991), passed in 1990, the SEC may impose civil penalties for violations of § 15(b)(4) or of §§ 15B or 15C. Under the Investment Advisers Act, the SEC has

[16] The majority of lower courts to analyze this section agree that none of the provisions of § 15 may be construed to create any private rights of action. *See, e.g., Asch v. Philips, Appel & Walden, Inc.*, 867 F.2d 776 (2d Cir. 1989), *cert. denied*, 493 U.S. 835 (1989); *Brannan v. Eisenstein*, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1313-14 & n.16 (9th Cir. 1982); Sally T. Gilmore & William H. McBride, *Liability of Financial Institutions for Aiding and Abetting Violations of Securities Laws*, 42 Wash. & Lee L. Rev. 811, 820 n.61 (1985) ("[c]ourts have rejected private aiding and abetting actions under Section 15") (citations omitted).

[17] Pursuant to § 19(h), 15 U.S.C. § 78s(h) (1988), a self-regulatory organization may suspend or expel any member or participant subject to an order under § 15(b)(4). Section 17A, 15 U.S.C. § 78q-1 (1988), grants the appropriate regulatory agency power to censure or discipline transfer agents or their associates for any violations of § 15(b)(4)(E), which expressly includes aiding and abetting.

authority to discipline any investment adviser who aids or abets violations of the securities laws. 15 U.S.C. § 80b-3(e)(5) (1988). The Commission may also obtain an injunction against any person who has aided or abetted or is about to aid or abet a violation of the Investment Advisers Act itself. 15 U.S.C. § 80b-9(d) (1988). Furthermore, under the Investment Company Act, the SEC may prevent any investment company or related organization from employing any person who has willfully aided or abetted a violation of the securities laws. 15 U.S.C. § 80a-9(b)(3) (1988).

Where one provision of the securities acts contains language which is not found in a second provision, the logical conclusion is that the language was intentionally left out of the second provision and should not be implied by the courts. *Touche Ross*, 442 U.S. at 571-72 (finding no implied private right of action under § 17(a), because Congress knew how to provide the private damage remedies it desired); *Ernst & Ernst*, 425 U.S. at 200-01 (use of different standards of scienter in the securities acts demonstrated that Congress did not intend a negligence standard for § 10(b)); *Blue Chip Stamps*, 421 U.S. at 733-34 (strict interpretation of "purchase or sale" requirement of § 10(b) supported by language of other securities provisions which reach fraud "in the offer or sale" of securities). Thus, the existence of aiding and abetting liability in other provisions of the 1934 Act strongly suggests that Congress has purposefully omitted such language from § 10(b) and from any express private rights of action.

"When Congress wished to provide a remedy" against aiders and abettors, "it had little trouble in doing so expressly." *Blue Chip Stamps*, 421 U.S. at 734. Congress has chosen to provide such a remedy within the 1934 Act only in the disciplinary context of SEC enforcement of various securities laws. Disregarding Congress' choice not to create private aiding and abetting liability under § 10(b) would endorse a dangerous and unwarranted expansion of the 1934 Act. "There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. Due to the

greatly expanded class of defendants who may be subjected to § 10(b) claims under an aiding an abetting regime, the right asserted by Respondents carries "[t]he same threats of speculative claims and procedural intractability" which the Court in the past has refused to countenance without strong evidence that the potential liability was intended by Congress. *Virginia Bankshares*, 111 S.Ct. at 2765.

3. Congress Has Specified What Secondary Liability It Intended To Create In Private Actions Under The 1934 Act.

"Those whose liabilities arise only because another has violated the law [are] called secondary wrongdoers." David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 600 (1972). Although Congress has chosen not to create a private right of action for aiding and abetting under the 1934 Act, it did impose another form of secondary liability, liability against controlling persons, in § 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1988).[18] Both aiding and abetting and controlling person liability are means of creating a claim against a defendant based on the violation of a third party due to some link between the defendant and the third party's conduct. *See* Fischel, *supra*, at 80 n.4 (court-imposed aiding and abetting liability and controlling person liability under § 20(a) are two possible types of secondary liability under the 1934 Act). Under § 20(a) the link is provided by the control relationship between the defendant and the primary violator; in an aiding and abetting case the link is the substantial assistance by the aider and abettor in the achievement of the primary violation. Congress explicitly provided secondary liability against the defendant in the former case, but did not create secondary liability against aiders and abettors. Just as

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[18] Respondents have not asserted a claim for controlling person liability against Central Bank, although they did bring such a claim against the director of the Developer. J.A. 3-27.

Congress knew how to impose aiding and abetting liability specifically when it wished to do so, it also knew how to impose liability derived from the conduct of another against a defendant in a private action. Congress has chosen not to impose such liability based on aiding and abetting.[19]

This Court most recently considered private rights of action under § 10(b) in *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085 (1993). In that decision, the court described § 10(b) as one of the provisions of the 1934 Act which "impose[s] direct liability on defendants for their own acts as opposed to derivative liability for the acts of others." *Id.* at 2090. Under this view, § 10(b) does not give rise to any claim for aiding and abetting, since aiding and abetting is a form of secondary liability "imposed on defendants who have not themselves been held to have violated the express prohibition of the securities statute at issue, but who have some relationship with the primary wrongdoer." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80 n.4 (1981); *see also* Ruder, *supra*, at 620 (securities aiding and abetting cases inpose a form of secondary liability).

By seeking to collect damages from Central Bank based upon a violation of § 10(b) allegedly committed by participants in the issuance of the 1988 Bonds, Respondents wish the Court to derive liability from the actions of a primary violator in much the same way that a court might under § 20(a). However, this Court concluded in *Musick* that §§ 9 and 18, not § 20, are the private rights in the 1934 Act most analogous to the implied right under § 10(b). The Court contrasted §§ 9 and 18, as well as § 10(b), which create direct liability, with § 20(a), which imposes derivative liability. *Musick*, 113 S. Ct. at 2090-91.

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[19] The fact that Congress considered civil aiding and abetting liability as a proposed addition to § 20, *see supra pp.* 20-22, supports the conclusion that § 20 is the exclusive source of secondary liability in private actions under the 1934 Act.

The creation of derivative liability beyond that approved by Congress through the theory of aiding and abetting circumvents the boundaries Congress intended for derivative liability under the securities laws. For example, to establish aiding and abetting liability, a plaintiff is relieved of proving a control relationship between the defendant and the defrauder. Yet it is this relationship which places the defendant in a position to prevent the improper conduct of the primary violator and makes it reasonable to impose liability for failure to do so. Moreover, the statutory defense of § 20 that the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action," 15 U.S.C. 78t (1988), is unavailable to aiding and abetting defendants. Thus, an implied aiding and abetting right would constitute an unwarranted expansion of the scope of derivative liability under the 1934 Act. "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." *Blue Chip Stamps*, 421 U.S. at 736 (footnote omitted).

As illustrated by this case, plaintiffs in securities fraud actions against controlling persons have taken to asserting aiding and abetting claims in addition to, or even instead of, controlling person claims, in the hopes of denying defendants the statutory defenses available in controlling person actions. Sally T. Gilmore & William H. McBride, 42 Wash. & Lee L. Rev. 811, 813-14 (1985). Such blatant attempts to avoid the parameters of derivative liability created by Congress cannot be countenanced. "[I]t is an elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19 (1979). Congress' limitation of derivative liability under the 1934 Act to controlling persons belies any inference that it would have intended to impose § 10(b) liability in private actions against aiders and abettors.

C. Judicial Creation Of A Private Right Of Action For Aiding And Abetting Violations Of Section 10(b) Improperly Applies Tort Law Concepts To Securities Law.

Unlike aiding and abetting rights of action in favor of the SEC, which courts often consider analogous to criminal aiding and abetting, private aiding and abetting rights have been implied by courts primarily by looking to general tort law principles of aiding and abetting. However, this Court has disavowed reliance on tort law principles in implying rights under the securities acts. The Court should not acquiesce in a rule applied by lower courts which disregards fundamental principles of statutory interpretation laid down by this Court.

The origins of aiding and abetting liability are far removed from the securities context in which Respondents today ask the Court to apply it. Aiding and abetting has long been understood to create criminal accomplice liability. The concept of aiding and abetting has also been widely adopted by courts as a theory for imposing tort liability.

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he
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> * * *
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

Restatement (Second) of Torts § 876 (1977). This theory of tort liability has been applied primarily to tortious conduct resulting in physical harm.[20]

The one area outside of the realm of physical torts in which courts have frequently applied aiding and abetting

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[20] Each of the sixteen illustrations to § 876 of the Restatement involves either physical harm to the plaintiff or destruction or burglary of his physical property.

liability is that of securities fraud, particularly in cases arising under § 10(b). *See* 4 Alan R. Bromberg & Lewis D. Lowenfels, *Securities Fraud & Commodities Fraud* § 8.5(614)(4), at 8:515 (1989) ("Apart form 10b-5 cases, Restatement sec 876 has been applied mainly to physical torts."). No lower court has declined to permit an implied private aiding and abetting right of action. However, although it has been increasingly questioned and criticized by certain lower courts[21] and by commentators,[22] very few decisions discuss in any detail the basis for an implied right of action for aiding and abetting under § 10(b). From those few that do, it appears that, unlike early SEC enforcement actions,[23] private aiding and abetting rights derive primarily from tort law. "The general statement of secondary liability appearing in

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[21] *See, e.g., Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 525 (5th Cir. 1992) ("There is a powerful argument that . . . aider and abettor liability should not be enforceable by private parties pursuing an implied right of action."); *Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co.*, 800 F.2d 177, 183 (7th Cir. 1986) ("We have frankly acknowledged that, in light of recent Supreme Court cases, there is some ambiguity about the existence of a civil cause of action for aiding and abetting a section 10(b) and Rule 10b-5 violation.") (footnotes omitted); *Little v. Valley Nat'l Bank*, 650 F.2d 218, 220 n. 3 (9th Cir. 1981) ("The status of aiding and abetting as a basis for liability under the securities laws is in some doubt."); *Benoay v. Decker*, 517 F. Supp. 490, 495 (E.D. Mich. 1981) ("It is also doubtful that a claim for 'aiding and abetting' or 'conspiracy' will continue to exist under 10(b). . . . [*Ernst & Ernst*] implicitly holds that aiding and abetting liability will not exist apart from liability for a direct violation. Recent commentary supports this view.") (citation and footnote omitted), *aff'd*, 735 F.2d 1363 (6th Cir. 1984).

[22] *See, e.g.*, Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80, 82 (1981) ("the theory of secondary liability is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws"); Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 Alb. L. Rev. 637, 651 (1988) (general criteria for implied private rights of action "weigh against an implied private action for aiding-abetting" under § 10(b) and Rule 10b-5).

[23] Courts have relied primarily upon criminal aiding and abetting in allowing the SEC to bring actions for aiding and abetting securities fraud, beginning with *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939) (applying criminal theory of aiding and abetting to an SEC enforcement action seeking injunctive relief because the suit was "similar in many respects to a criminal prosecution").

section 876 of the *Restatement of Torts* has been seized upon by some courts as providing a source of liability for secondary defendants." Ruder, *supra*, at 620 (footnote omitted); *see also* 5B Arnold S. Jacobs, *Litigation and Practice Under Rule 10b-5* § 40.02, at 2-417 to 2-418 (2d ed. 1991).

Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), is the first, and perhaps only, decision to attempt to rigorously justify the underpinnings of an implied § 10(b) aiding and abetting right of action. In creating such a right, *Brennan* made clear its heavy reliance upon section 876 of the *Restatement of Torts*. The court defended its use of the *Restatement* by asserting that "[a]ppropriate general principles of law should continue to guide the development of federal common law remedies under Section 10(b) and Rule 10b-5. . . . [Such principles] surely best fulfill the purposes of the Securities Exchange Act of 1934 and are a logical and natural complement" to the private right against primary violators. 259 F. Supp. at 680. Subsequent courts have continued to apply the *Restatement* concept of aiding and abetting to 10b-5 litigation, as illustrated by the elements required for § 10(b) aiding and abetting liability – (1) a securities law violation by the primary violator; (2) knowledge of the violation on the part of the aider and abettor; and (3) substantial assistance by the aider and abettor. *E.g.*, *K & S Partnership v. Continental Bank*, 952 F.2d 971, 977 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 2993 (1992). These elements closely parallel the requirements for aiding and abetting liability under section 876(b) of the *Restatement*, that the defendant "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself."

This reliance on general tort theory to imply a private right against aiders and abettors is no longer viable. This Court has resoundingly rejected application of general tort law principles to create private rights of action under the securities laws. In *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979), the Court emphasized that the existence of a right of action under the securities laws is solely a question of

statutory construction and Congressional intent. An "argument in favor of implication of a private right of action based on tort principles, therefore, is *entirely misplaced*." *Id* (emphasis added); *see also Blue Chip Stamps*, 421 U.S. at 744-45 ("[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable."); *Herman & MacLean*, 459 U.S. at 388 ("Reference to common-law practices can be misleading.").[24] Moreover, reliance upon this section of the *Restatement* is questionable in the securities context, which is very different from the context of physical torts for which the section was intended. "Since section 876 of the *Restatement of Torts* deals primarily with liability for physical harm rather than liability in the business or economic setting, it should be relied upon with caution in invoking securities law liability." Ruder, *supra*, at 621.

Because lower courts have developed a private right for aiding and abetting from general tort law principles, a practice this Court has since expressly disapproved, the Court should not acquiesce in the rule followed by the lower courts. Although the Court on other occasions had stated a willingness to recognize an implied private right of action which has gained acceptance in the lower courts, it has done so only when the right had already been tacitly accepted by the Court or its recognition was consistent with guiding principles previously provided by the Court. *See, e.g., Blue Chip Stamps*, 421 U.S. at 730 (implication of an implied private right of action against primary violators of § 10(b) by the lower courts "was, of course, entirely consistent with the Court's recognition in *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964), that private enforcement of Commission rules may '[provide] a

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[24] This view evidences the Court's evolution towards strict statutory construction and away from the concept embodied in *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), that private rights in securities actions should be permitted whenever necessary to fulfill the general purposes of the securities acts. *Touche Ross*, 442 U.S. at 578; *Virginia Bankshares*, 111 S.Ct. at 2763. The logic of *Brennan* mirrors the outdated *J. I. Case* approach.

necessary supplement to Commission action.' "); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 380 (1982) (recognizing implied right under Commodity Exchange Act where, in prior decisions, "*[t]his Court*, as did other federal courts and federal practitioners, simply assumed that the remedy was available") (emphasis added); *Cannon v. University of Chicago*, 441 U.S. 677, 702-03 (1979) (recognizing implied right under Title IX for sex discrimination which had been persistently assumed by lower courts and was "even *implicit in decisions of this Court*") (emphasis added). In contrast, the Court has been careful not to endorse the lower courts' recognition of a private aiding and abetting right under § 10(b), *Ernst & Ernst*, 425 U.S. at 191 n.7; *Herman & MacLean*, 459 U.S. at 379, n.5, and implication of the right based on tort law concepts is emphatically not consistent with the Court's stated views of private rights under the securities acts. The Court is not bound to follow a rule created in the past by lower courts which is contrary to subsequent teachings of the Court.

Reliance upon tort law is also inappropriate because tort law in general, and aiding and abetting liability in particular, is an area traditionally relegated to states. *Cort v. Ash*, 422 U.S. 66, 78 (1975), has described one of the criteria of whether a private right of action should be implied as whether "the cause of action [is] one traditionally relegated to state law in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law." Since the common law rule of aiding and abetting stated in section 876 of the *Restatement* is normally a matter of concern in state tort law, it does not appropriately give rise to an implied federal right of action. Bromberg & Lowenfels, 52 Alb. L. Rev. at 657. Furthermore, aiding and abetting improper sales of securities has traditionally been a concern of state blue sky laws, which also brings such claims within the scope of a traditional area of state law. *Id* at 659.[25]

[25] For example, aiders and abettors of securities frauds are subject to statutory civil liability in Colorado. Colo Rev. Stat. § 11-51-604(5)(c) (Supp. 1992).

This criterion from *Cort v. Ash* thus weighs against implying a private right of action for aiding and abetting under § 10(b).[26]

Application by this Court of the tort concept of aiding and abetting to § 10(b) would be an unwarranted extension of private civil liability. Whereas the implied private right under § 10(b) endorsed by the Court in the past merely expands the class of plaintiffs who may sue violators of § 10(b), aiding and abetting creates an entirely new category of defendants who may be held jointly and severally liable for damages resulting from the primary violation of another. The statute provides no justification for subjecting such a class of defendants to potential securities liability, especially where the right improperly originates from tort theory and where Congress purposefully restricted aiding and abetting under the 1934 Act to disciplinary actions by the SEC. Therefore, the Court should affirm the district court's grant of summary judgment in favor of Central Bank.

II. CENTRAL BANK MAY NOT BE HELD LIABLE TO RESPONDENTS BASED ON MERE RECKLESSNESS, BECAUSE ACTUAL KNOWLEDGE OR CONSCIOUS INTENT IS REQUIRED TO SATISFY THE SCIENTER REQUIREMENT FOR AIDING AND ABETTING VIOLATIONS OF SECTION 10(b) AND RULE 10b-5 ABSENT A DUTY TO DISCLOSE OR TO ACT.

Even if a private right of action exists against defendants for aiding and abetting violations of § 10(b) or Rule 10b-5, such a right cannot extend to Central Bank in this case.

Both the district court and the court of appeals determined that Central Bank, whose duties as indenture trustee were strictly limited to those specified in the Indenture, did not owe a duty to disclose to Respondents. J.A. 203. The court of appeals made no finding that Central Bank had failed to meet any of its duties as trustee and did not reach the

[26] Each of the other four factors identified in *Cort v. Ash* are addressed by the above discussion of Congressional intent, *Touche Ross*, 442 U.S. at 575-76, and also weigh against recognition of an implied private right.

question of whether Central Bank had knowledge of the alleged fraud, holding instead that Central Bank could be liable as an aider and abettor to the alleged securities fraud if it recklessly[27] provided assistance by action. J.A. 210. The court embraced the Ninth Circuit's minority view that recklessness may satisfy the requirement of scienter in a § 10(b) aiding and abetting case even if the defendant had no duty to disclose or act, and went even beyond the Ninth Circuit's position, which requires some actual misrepresentation by the defendant, by holding that recklessness suffices whenever the defendant has taken any affirmative action. This rule utterly disregards the crucial requirement in any 10(b) case of manipulative or deceptive conduct by the defendant. The court of appeals eschewed the rule followed by the majority of courts, which recognizes that recklessness cannot be considered a form of deceptive conduct where there is no duty owed by the defendant. The approach of the court below does not provide a workable standard for aiding and abetting liability and would invite litigation against a host of defendants § 10(b) was never intended to reach.

A. No Action Under Section 10(b) Or Rule 10b-5 May Be Maintained Without Proof Of Manipulative Or Deceptive Conduct By The Defendant.

In determining the scienter requirement in any § 10(b) or Rule 10b-5 case, "the starting point for our inquiry is *Ernst & Ernst v. Hochfelder* . . . Although the issue presented in the present case was expressly reserved in *Hochfelder,* we nonetheless must be guided by the reasoning of that decision." *Aaron v. SEC,* 446 U.S. 680, 689-90 (1980) (citation omitted). As was the case in *Aaron,* the Court declined to rule on the present issue in *Ernst & Ernst.* The Court reserved the question of "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5,"

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[27] The court defined recklessness as "conduct that is 'an extreme departure from the standards of ordinary care, and which presents a danger . . . that is either known to the defendant or is so obvious that the actor must have been aware of it.' " J.A. 210 (quoting *Hackbart v. Holmes,* 675 F.2d 1114, 1118 (10th Cir. 1982)).

425 U.S. at 193 n.12, and further reserved the question of what elements are necessary to establish a civil aiding and abetting claim if such a claim is appropriate. 425 U.S. at 191 n.7; *see also Herman & MacLean,* 459 U.S. at 378 n.4; *Aaron,* 446 U.S. at 686 n.5. Nevertheless, as was true in *Aaron,* "the rationale of *Hochfelder* ineluctably leads to the conclusion" that the scienter rule advanced by Respondents is inadequate to meet the requirements of § 10(b). 446 U.S. at 691.

In *Ernst & Ernst v. Hochfelder,* the Court rejected the view held by many of the courts of appeals at that time that civil liability under § 10(b) could be based only on negligence. *See, e.g., White v. Abrams,* 495 F.2d 724, 730 (9th Cir. 1974); *Myzel v. Fields,* 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); *Kohler v. Kohler Co.,* 319 F.2d 634, 637 (7th Cir. 1963). In response to the SEC's position that a negligence rule would best further the Congressional purpose of protecting investors,[28] the Court stated:

> [A]part from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. The argument simply ignores the use of the words 'manipulative,' 'device,' and 'contrivance' – terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

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[28] Although the Commission endorsed a negligence standard in *Ernst & Ernst,* it suggested that certain additional requirements be imposed before negligence would be considered sufficient, including that the defendant knew or could foresee that the plaintiff would rely on his conduct. 425 U.S. at 198 n.18. This added requirement is functionally similar to the majority rule's requirement of a duty to disclose or act before recklessness liability may be imposed in an aiding and abetting case. *See* Section II.B.1., *infra.*

425 U.S. at 198-99 (citation and footnotes omitted). The use of such strong language in § 10(b) compelled the Court's conclusion that § 10(b) "clearly connotes intentional misconduct" by the defendant. *Id.* at 201.

The requirement is not obviated by a defendant's status as an aider and abettor rather than the primary violator. The aider and abettor, like any § 10(b) defendant, must be guilty of some sort of "intentional misconduct." *Id.* This requirement adheres to the standard for aiding and abetting endorsed by this Court in the criminal context in *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949). There the Court adopted Judge Learned Hand's view of aiding and abetting stated in the seminal case of *United States v. Peoni*, 100 F.2d 401 (2d Cir. 1938). Reviewing the various existing definitions of accomplice liability, Judge Hand concluded that aiding and abetting requires that the defendant "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed. All the words used – even the most colorless, 'abet' – carry an implication of purposive attitude towards it." *Id.* at 402.[29]

Whereas the requirement of willful conduct contained in *Ernst & Ernst* echoes the *Peoni* scienter standard, the court below has entirely abandoned Judge Hand's conception of aiding and abetting liability. Relying solely on a tenuous distinction between action and inaction, the court of appeals has allowed an aiding and abetting claim against Central Bank to proceed without any evidence that Central Bank engaged in any intentional or deceptive conduct, that it knew of or intended to further the alleged primary fraud, or that it had any duty to discover or disclose the primary fraud. Imposition of liability against Central Bank in these circumstances cannot be reconciled with the crucial requirement under § 10(b) of manipulative or deceptive conduct by the defendant.

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[29] The Model Penal Code similarly requires a "purpose of promoting or facilitating the commission of an offense." *Model Penal Code* § 2.06(3)(a) (1962).

Certainly Central Bank was not a party to any manipulation, a "term of art" which "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (citations omitted); *see also Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 7-8 (1985). The court below offered no explanation as to how Central Bank's conduct might be considered deceptive where it owed no duty to Respondents. The more logical view, embraced by most lower courts, is that reckless conduct by a defendant is not deceptive where, as here, there is no underlying relationship giving rise to a duty owed by the defendant to the plaintiff.

B. Because It Did Not Owe A Duty To Disclose Or To Act, Central Bank Engaged In No Deceptive Conduct Where It Committed No Independent Fraudulent Acts And Where It Had No Actual Knowledge Of Or Conscious Intent To Further The Fraudulent Act Of Another.

In contrast to the court below, the great majority of the courts of appeals impose liability for aiding and abetting based on recklessness only in situations where recklessness may reasonably be deemed a type of deceptive conduct under § 10(b). While any aiding and abetting theory is inherently at odds with the "manipulative or deceptive" requirement of § 10(b) as explained by *Ernst & Ernst*, *see* Section I.A., *supra*, most courts at least attempt to restrict aiding and abetting liability to conduct of an arguably manipulative or deceptive nature. The majority of the circuits require actual knowledge of the fraud or conscious intent to further the fraud where the defendant owed the plaintiff no affirmative duty to act or disclose. The Seventh Circuit requires an independent fraudulent act by the aider and abettor. Neither of these rules would permit an aiding and abetting claim against Central Bank.

1. The Scienter Standard Applied By Most Courts, Which Requires Actual Knowledge Or Conscious Intent For Aiding And Abetting Liability Absent A Duty To Disclose Or To Act, Would Not Permit Liability Against Central Bank.

The courts of appeals uniformly require three elements for aiding and abetting a § 10(b) violation: "(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *E.g., IIT v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980). The Second, Third, Fourth, and Eighth Circuits use this test essentially verbatim. *See, e.g., id.; Landy v. FDIC,* 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974); *Schatz v. Rosenberg,* 943 F.2d 485, 495 (4th Cir. 1991), *cert. denied,* 112 S. Ct. 1475 (1992); *Metge v. Baehler,* 762 F.2d 621, 624 (8th Cir. 1985), *cert denied,* 474 U.S. 1057 (1986). A variant of the test restates the second and third elements as "the defendant's general awareness that his role was part of an overall activity that is improper" as well as "knowing and substantial assistance." *Cleary v. Perfectune, Inc.,* 700 F.2d 774, 777 (1st Cir. 1983). The District of Columbia, First, Fifth, Sixth, and Eleventh Circuits use this language. *See, e.g., id; Investors Research Corp. v. SEC,* 628 F.2d 168, 178 (D.C. Cir. 1982), *cert. denied,* 449 U.S. 919 (1980); *Fine v. American Solar King Corp.,* 919 F.2d 290, 300 (5th Cir. 1990), *cert. dismissed,* 112 S. Ct. 576 (1991); *Moore v. Fenex, Inc.,* 809 F.2d 297, 303 (6th Cir. 1987), *cert. denied,* 483 U.S. 1006 (1987); *Woods v. Barnett Bank of Fort Lauderdale,* 765 F.2d 1004, 1009 (11th Cir. 1985). As will be seen, the two variations of the majority test do not lead to markedly different results.

The requirement of knowledge of the fraud is intended to meet the scienter standard of *Ernst & Ernst.* Rather than attempt to interpret this element according to a bright-line rule, most courts conform to a variable scienter test. Joel S. Feldman, *The Breakdown of Securities Fraud Aiding and*

Abetting Liability: Can a Uniform Standard Be Resurrected?, 19 Sec. Reg. L. J. 45, 53-57 (1991) (describing in detail scienter requirement employed by majority of circuits). Under the majority's approach, the scienter requirement increases from recklessness to either actual knowledge of the fraud or conscious intent to further the fraud where the defendant owed the plaintiff no duty to disclose or act.[30] The First,[31] Second,[32] Third,[33] Fourth,[34]

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[30] Whether actual knowledge or conscious intent is required is generally determined by whether the defendant assisted by action or inaction. *Id.* In light of the Court's language in *Ernst & Ernst,* the better view is that conscious intent is necessary without regard to the defendant's action or inaction. Whichever approach is adopted by the Court, the decision below was improper since the Tenth Circuit required recklessness only.

[31] *Cleary v. Perfectune, Inc.,* 700 F.2d 774, 777 (1st Cir. 1983) ("Courts generally have held that in the absence of a duty of disclosure, a defendant should be held liable as an aider and abettor only if the plaintiff proves that the defendant had actual knowledge of the improper activity of the primary violator and of his role in that activity. *Woodward v. Metro Bank of Dallas,* 522 F.2d at 96.") (additional citations omitted).

[32] *Armstrong v. McAlpin,* 699 F.2d 79, 91 (2d Cir. 1983) ("[I]f the alleged aider and abettor owes a fiduciary duty to the plaintiff, recklessness is enough. If there is no fiduciary duty, the 'scienter' requirement scales upward – the assistance rendered must be knowing and substantial.") (citations omitted); *see also Ross v. Bolton,* 904 F.2d 819, 824 (2d Cir. 1990); *National Union Fire Ins. Co. v. Turtur,* 892 F.2d 199, 206-07 (2d Cir. 1989); *IIT v. Cornfeld,* 619 F.2d 909, 923-25 (2d Cir. 1980); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.,* 602 F.2d 478, 484-85 (2d Cir. 1979), *cert. denied,* 444 U.S. 1045 (1980); *Rolf v. Blyth, Eastman, Dillon & Co.,* 570 F.2d 38, 44-45 (2d Cir. 1978), *cert. denied,* 439 U.S. 1039 (1978).

[33] *Walck v. American Stock Exch., Inc.,* 687 F.2d 778, 791 (3d Cir. 1982) ("With no allegation that the Exchanges had actual knowledge of E&H's conduct in violation of § 10(b) and Rule 10b-5 leading to the plaintiffs' purchases of Trans-Lux stock, the complaint fails to allege the existence of the elements necessary for relief under a theory of aiding and abetting an independent violation of the law."), *cert. denied,* 461 U.S. 942 (1983); *see also Monsen,* 577 F.2d at 799-800; *Rochez Bros. v. Rhoades,* 527 F.2d 880, 886-87 (3d Cir. 1975); *Landy v. FDIC,* 486 F.2d 139, 162-64 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974).

[34] *Schatz v. Rosenberg,* 943 F.2d 485, 496 (4th Cir. 1991) ("[A]n evaluation of the 'knowledge' requirement of the aiding and abetting liability test turns upon whether the aider and abettor defendant owed a duty to the plaintiff. When there is no duty running from the alleged aider and abettor to the plaintiff, the defendant must possess a 'high conscious intent' and a 'conscious and specific motivation' to

Fifth,[35] Eighth,[36] and Eleventh[37] Circuits have each held in accordance with the majority rule that where the defendant owes no duty, either actual knowledge or conscious intent to further the fraud, depending upon the circumstances, is required.[38] The District of Columbia and Sixth Circuits have not yet had the opportunity to so hold, but language in certain of their decisions is consistent with the majority view.[39]

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aid the fraud.") (citing *IIT*, 619 F.2d at 925; *Woodward*, 522 F.2d at 97), *cert. denied*, 112 S. Ct. 1475 (1992).

[35] *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975) ("When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved."); *see also Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1126-27 (5th Cir. 1988), *cert. denied*, 492 U.S. 918 (1989), *and vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989).

[36] *Camp v. Dema*, 948 F.2d 455, 462 (8th Cir. 1991) ("Because Kidder did not owe Camp a duty to disclose, the knowledge requirement may not be satisfied by recklessness."); *see also K & S Partnership v. Continental Bank*, 952 F.2d 971, 978 (8th Cir. 1991), *cert. denied*, 112 S. Ct. 2993 (1992); *Metge v. Baehler*, 762 F.2d 621, 625 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

[37] *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985) ("A defendant who is not under any duty to disclose can be found liable as an aider and abettor only if he acts with a high degree of scienter, that is, with a 'conscious intent' to aid the fraud.").

[38] This variable scienter standard is most commonly referred to as the "sliding scale" test. *See* Feldman, *supra*. This term has also at times been used to describe the related concepts advanced by certain courts that conscious intent is required despite actions taken by the defendant where the actions occur in the course of ordinary business transactions, *e.g.*, *Camp.*, 948 F.2d at 464; *Schatz*, 943 F.2d at 497; *Monsen*, 579 F.2d at 799 n.9, and that the level of evidence required to prove actual knowledge may increase where the defendant's participation in the alleged wrongdoing is less substantial. *E.g.*, *Schneberger v. Wheeler*, 859 F.2d 1477, 1480-81 (11th Cir. 1988). To avoid any ambiguity, the term "majority rule" is used in this brief to convey the aspect of the sliding scale test pertinent here, that recklessness is not adequate scienter where the defendant owes no duty to disclose or to act.

[39] *See Dirks v. SEC*, 681 F.2d 824, 825 n.28 (D.C. Cir. 1982) (extraordinary degree of scienter not necessary where defendant owed a duty to the public and knew of fraudulent transactions), *rev'd on other grounds*, 463 U.S. 646 (1983); *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 226 (6th Cir. 1982) (less evidence of knowledge necessary where defendant owed a fiduciary duty).

The scienter standard employed by the majority of the courts of appeals allows liability based upon recklessness, while at the same time attempting to adhere to the scienter requirements of *Ernst & Ernst*. Unless *Ernst & Ernst*'s teachings as to the purpose of § 10(b) are to be entirely abandoned, recklessness can be sufficient only where there is some legitimate basis for considering the reckless conduct to be akin to "a manipulative or deceptive device or contrivance." The majority rule's requirement of actual knowledge or conscious intent in the absence of a duty to disclose or act seeks to provide this basis.[40] This Court has recognized in the securities context that conduct which would otherwise not be actionable can rise to the level of fraud where the defendant owed some sort of duty, particularly a disclosure duty, to the plaintiff. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Court held that silence in connection with the purchase or sale of a security can be deemed fraudulent conduct only if the defendant owed a pre-existing disclosure duty. Simply put, "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 235. A duty to speak is thus of obvious significance in interpreting the antifraud provisions of the securities laws, which "are directed at failures to disclose." *Schreiber*, 472 U.S. at 8.

The majority rule proceeds from this simple premise. Recklessness may assume a character of deception where the defendant owes an affirmative duty, just as silence may become deceptive where there is a duty to disclose. "To be actionable, of course, a statement must also be misleading. Silence, *absent a duty to disclose*, is not misleading under Rule 10b-5." *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) (emphasis added). Silence does not work deception upon another unless a relationship exists such that one is

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[40] Thus, while the majority rule does not follow a strict reading of *Ernst & Ernst*, which would require conscious intent without regard to any disclosure duties, it at least bears some relationship to the "manipulative or deceptive" requirement of *Ernst & Ernst* and § 10(b), unlike the Tenth Circuit's new standard. *See* Section II.C.1., *infra*.

expected to speak. By the same token, recklessness is misleading or deceptive only where there is some relationship which reasonably created in another person the expectation that the reckless party would take steps to protect that person's interests. Such an expectation is reasonable where there was a preexisting duty to disclose or act. The majority rule, by its requirement of a duty to disclose or act, therefore, attempts to ensure that liability will be imposed only where the reckless conduct could legitimately be deemed a type of manipulative or deceptive practice.

In this matter, the majority rule would not permit aiding and abetting liability against Central Bank without evidence of actual knowledge of the alleged fraud or conscious intent to further the fraud, because the bank did not owe any duty to Respondents under the circumstances. Central Bank's conduct of delaying its demand for an independent appraisal was discretionary and was not in disregard of any duty owed.[41] With hindsight, Respondents now criticize the timing of Central Bank's decision but cannot claim to have been deceived by such action, which the Indenture clearly disclosed beforehand as an option of the trustee. The mere fact that actions taken by a party may in other contexts be considered reckless does not in any way render the conduct manipulative or deceptive under § 10(b), any more than actions which rise to the level of ordinary negligence may be considered deceptive. *See Ernst & Ernst,* 425 U.S. at 214.

By requiring actual knowledge or conscious intent before aiding and abetting liability may be imposed in the absence of a duty to disclose or to act, the majority rule applies a scienter standard which at least attempts to follow the "manipulative or deceptive" language of § 10(b) and the teachings of *Ernst*

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[41] Under the Indenture, the Trustee has "the right, but shall not be required, to demand any . . . appraisals . . . deemed desirable for the purpose of . . . any other action by the Trustee." Indenture, § 9.01(k). The discretion to delay exercising a right, or to forego it altogether, is likewise protected by the Indenture: "The permissive right of the Trustee to do things enumerated in this Indenture shall not be construed as a duty . . . " Indenture, § 9.01(g). See J.A. 143-45.

& Ernst. Under this standard, Central Bank may not be liable under § 10(b) for reckless aiding and abetting.

2. The Seventh Circuit Aiding And Abetting Standard, Which Requires A Manipulative Or Deceptive Act By The Defendant, Also Would Not Permit Aiding And Abetting Liability Against Central Bank.

The Seventh Circuit goes even beyond the majority rule by requiring, in addition to the three elements listed above, that an aider and abettor must have "himself committed one of the 'manipulative or deceptive' acts or otherwise met the standards of direct liability (save for the fact that he did not offer or sell the securities)." *Barker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490, 495 (7th Cir. 1986). Plaintiffs have not even alleged that Central Bank's conduct meets the standards for a primary violation of § 10(b). Since Central Bank here is charged only with recklessly assisting fraudulent conduct, rather than itself committing a fraudulent act, it could not be held liable under this test.

In the *Barker* case, Judge Easterbrook prefaced the Seventh Circuit's rule with a discussion of the need to adhere to *Ernst & Ernst*'s conception of § 10(b). "A court must take care lest the implied right of action under Rule 10b-5 unravel the presumptions and defenses created by Congress." *Id.* In the later case of *Robin v. Arthur Young & Co.,* 915 F.2d 1120, 1126 (7th Cir. 1990), *cert. denied,* 111 S.Ct. 1317 (1991), the court defended a strict intent standard by observing that "it is the intent requirement that distinguishes an action for securities fraud from an action for negligence or malpractice."

At the time of *Ernst & Ernst,* the Court was already concerned with suggested standards of liability which "would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts." 425 U.S. at 214 n.33. If aiding and abetting claims are deemed appropriate under § 10(b), yet unwarranted expansion of civil liability under § 10(b) continues to be a concern of the Court, the Seventh Circuit aiding and abetting

standard, which is calculated to remain faithful to the analysis of *Ernst & Ernst*, is a logical alternative.

C. By Allowing Aiding And Abetting Liability Based On Recklessness Whenever There Is Assistance By Action, The Court Of Appeals Fails To Require Manipulative Or Deceptive Conduct And Creates An Unworkable Scienter Standard.

Although conceding that some courts have held "that recklessness is not sufficient scienter for aiding-and-abetting liability unless the defendant has a fiduciary duty," J.A. 206 (citations omitted), the court of appeals chose not to follow this majority rule and instead held that "in an aiding-and-abetting case based on assistance by action, the scienter element is satisfied by recklessness." J.A. 210. This action-inaction dichotomy, permitting liability based on recklessness whenever the defendant has taken some affirmative act, apparently originated in the Ninth Circuit,[42] although even the Ninth Circuit has not held that *any* action by the defendant reduces the scienter standard to recklessness. *See Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1484 n.4 (1991) (court need not consider whether defendant has a duty to disclose where aiding and abetting liability is premised on actual

[42] The court of appeals also purported to rely on the Eight Circuit's opinion in *FDIC v. First Interstate Bank*, 885 F.2d 423, 432-33 (8th Cir. 1989). In that case the court found that the defendant *did* have a duty to disclose and could therefore be held liable for aiding and abetting based on recklessness. *Id.* at 433. The court went on to note that because the claims against the defendant were not based only on inaction, plaintiff did not need to show that the defendant consciously intended to defraud. *Id.* This merely follows the rule under the majority's sliding scale that conscious intent is required only in cases based on inaction. *See supra* n.30. Subsequent decisions confirm that the Eighth Circuit did not abandon the majority rule in its *FDIC* opinion. *See K & S Partnership v. Continental Bank*, 952 F.2d 971, 978 (8th Cir. 1991) (quoting proposition from *Woodward* that "[w]hen it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved"), *cert. denied*, 112 S.Ct. 2993 (1992); *Camp v. Dema*, 948 F.2d 455, 462 (8th Cir. 1991) ("Because Kidder did not owe Camp a duty to disclose, the knowledge requirement may not be satisfied by recklessness. *See FDIC*, 885 F.2d at 432-33.").

misrepresentations rather than silence).[43] The scienter test utilized by the court below disregards the requirement emphasized in *Ernst & Ernst* of manipulative or deceptive conduct, instead relying on an unworkable and conceptually flawed distinction.

1. The "Assistance By Action" Rule Utilized By The Court Of Appeals Is Unrelated To The Scienter Requirement Identified In *Ernst & Ernst*.

For guidance as to the appropriate standard of scienter, both the Ninth Circuit and the court below look simply to whether the defendant took some affirmative action in its role as aider and abettor. By discarding the majority rule's initial inquiry as to the defendant's duty to disclose or act, this minority rule ignores the course charted by this Court in *Ernst & Ernst*, by which courts must look to the deceptiveness of the defendant's conduct with respect to the plaintiff, and deviates even further from Judge Hand's traditional view of the aider and abettor as one who actively seeks to bring about the unlawful result.

As seen above, where the defendant owes some duty to the plaintiff, reckless acts which otherwise would not be actionable under the securities laws may fairly be regarded as of a deceptive nature. Conduct of the defendant may assume an additional misleading quality where he knows he is subject to a disclosure duty. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988). There is no analogous basis for deeming a defendant to be guilty of deception or manipulation based on reckless actions where a reckless failure to act by the same defendant would not be considered manipulative or deceptive. As interpreted by *Ernst & Ernst*, § 10(b) contains a strict requirement as to the defendant's state of mind. Yet the

[43] Under the majority rule, a duty to disclose or to act is required to impose liability even for an aider and abettor's reckless misrepresentations. *See, e.g., Ross*, 904 F.2d at 822, 824 (defendant clearing agent allegedly misrepresented brokerage firm's solvency; court held recklessness insufficient for aiding and abetting liability absent any fiduciary duty); *IIT*, 619 F.2d at 923-24 (underwriter defendants circulated prospectus containing misrepresentations; court held recklessness satisfied scienter requirement where defendants owed plaintiffs a fiduciary duty).

defendant's state of mind is no different whether he assists the fraud by action or inaction.

Moreover, the rule utilized by the court below requires less than even the Ninth Circuit's approach. The Ninth Circuit has reduced the scienter requirement to recklessness based on affirmative actions only where the actions constitute "actual misrepresentations." *Levine*, 950 F.2d at 1484 & n.4 (finding especially significant the fact that defendant trust company issued deceptive confirmations to investors). Thus, even the Ninth Circuit at least searches for some conduct of a deceptive nature. The court below recognized no such limitation, deeming recklessness sufficient in any "aiding-and-abetting case based on assistance by action." J.A. 210.

The failure of the Tenth Circuit's new standard to adhere to the *Ernst & Ernst* scienter requirement is amply illustrated by this very case. The court of appeals stressed that Respondents' claim against Central Bank was not based only on inaction, but also on the allegation "that Central Bank assisted the primary violation by *affirmative action*, specifically by affirmatively agreeing to delay the independent review of the Hastings appraisal." J.A. 207. Yet is was Central Bank itself which, as Trustee, exercised its discretion and initially requested an independent review of the appraisal. If Central Bank had simply ignored the concerns raised about the appraisal and had never requested such a review, the case would have been one of inaction and liability could not be imposed based on mere recklessness even under the minority rule. Yet Central Bank's state of mind would be unchanged in the latter case. The court of appeals' "assistance by action" rule is therefore impermissibly divorced from any reasonable evaluation of scienter.

2. The "Assistance By Action" Rule Does Not Provide A Workable Standard For Determining The Requisite Scienter For Aiding And Abetting A Violation Of Section 10(b) Or Rule 10b-5.

The court of appeals' "assistance by action" scienter standard proceeds solely from the distinction between action

and inaction, a distinction which is hopelessly blurred in many aiding and abetting cases. To focus solely on whether the defendant took some affirmative action in assisting the primary violator is to invite confusion and inconsistent results in this area of the law. By definition, the aider and abettor is not the party which committed the acts constituting the primary violation of § 10(b).[44] Conversely, one can imagine only with difficulty an entity substantially assisting a fraud and becoming implicated as an aider and abettor without undertaking any affirmative conduct whatsoever. The conduct of any aider and abettor must be expected to defy ready categorization as action or inaction. At best, "[t]he distinction between positive action and deliberate inaction is elusive." *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

Again the Court need look no further than the instant case for an illustration of the insubstantial character of the court of appeals' "assistance by action" standard. The conduct characterized by the Respondents and the Tenth Circuit as affirmative action by reason of Central Bank's agreement to delay the independent review of the appraisal can also fairly be described as inaction, *i.e.*, Central Bank's failure to insist upon an independent review before the 1988 Bonds were issued. It is evident that a case which would ordinarily be considered to arise from the defendant's inaction may easily be couched in terms of "assistance by action" by a plaintiff or even a court so inclined.[45] A reliable scienter test cannot be founded solely on this tenuous, subjective standard.

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[44] As explained above, only in the Seventh Circuit is the aider and abettor expected himself to "commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b-5." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990), *cert. denied*, 111 S.Ct. 1317 (1991); *see* Section II.B.2., *supra*.

[45] Several cases decided in other circuits which the courts analyzed as based on inaction likely would be deemed affirmative action cases under the Tenth Circuit's loose standard. *See, e.g., Metge*, 762 F.2d at 623-24 (defendant was "heavily involved" in financing primary violator and engaged in various strategies to keep it in business, yet court characterized its involvement as inaction); *IIT*, 619 F.2d at 925-27 (focusing on whether "mere inaction" could give rise to aiding and abetting claim, where defendant accountant audited and certified allegedly inaccurate financial statements).

Furthermore, such facile categorizations of action and inaction will invariably subject banks, accountants, lawyers or other professionals who "assist" in a purchase or sale of securities to liability under a recklessness standard with no analysis of whether the conduct transgressed a duty owed to the plaintiffs. As stated by the court of appeals: "the *Levine* court considered the case before it as one based upon assistance by action and for that reason expressly found irrelevant the question whether the alleged aiders-and-abettors had a duty to disclose." J.A. 208. While the majority position considers the duty question in an attempt to ensure that the conduct of the alleged aider and abettor at least had the characteristics of deception, the court of appeals simply abandons the inquiry in favor of a *per se* rule equating reckless, affirmative action with deception. The practical effect of this approach on Central Bank and others assisting in such transactions is to bootstrap a duty where none exists as a matter of state law, contrary to this Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), and to create an unwarranted presumption that the alleged aider and abettor intended to defraud the plaintiff simply because its conduct was later judged as reckless.

D. A Recklessness Standard Divorced From Any Duty To Disclose Or To Act Would Invite Unduly Expanded Section 10(b) Litigation Against A Host Of Legitimate Business Entities.

Finally, the Court must consider the impact a ruling affirming the Tenth Circuit's standard of recklessness based upon affirmative action would have. The Court has traditionally been wary of expanding potential claims under § 10(b). *Ernst & Ernst*, 425 U.S. at 214 n.33. It has observed that there is a heightened danger of vexatious litigation in the § 10(b) arena, *Blue Chip Stamps*, 421 U.S. at 739, and has

concluded that it is best left to Congress to determine when an expansion of private litigants' rights under the securities laws is warranted. *Touche Ross*, 442 U.S. at 579.

These concerns must carry particular weight in the aiding and abetting context of the present litigation. Any expansion of private aiding and abetting rights of action under § 10(b) can affect uncounted professionals and business entities, particularly banks, accountants, and securities lawyers who participate in purchases or sales of securities. Where the expansion takes the form of a relaxation of the requirement of scienter, the potential for new liability among these groups is especially significant. The potential liability against a bank in the present case calls to mind Professor Ruder's concern regarding the potential impact of § 10(b) aiding and abetting liability against banks where knowledge is not required:

> Imposition of such liability upon banks would virtually make them insurers regarding the conduct of insiders to whom they loan money. If it is assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. *Knowledge of wrongful purpose thus becomes a crucial element in aiding and abetting or conspiracy cases.*

Ruder, *supra*, at 630-31 (emphasis added). It is this requirement of knowledge of wrongful purpose which Respondents ask this Court to dramatically reduce, even below the fairly permissive standard followed by the majority of the courts of appeals.

Relaxation of the scienter requirement in § 10(b) aiding and abetting cases can generate such dramatic impact because of the nature of the § 10(b) provision. In comparison to other securities provisions, "§ 10(b) is a 'catchall' antifraud provision, but it requires a plaintiff to carry a heavier burden to establish a cause of action." *Herman & MacLean*, 459 U.S. at

382 (footnote omitted). Because § 10(b) is written as a catch-all provision, adjustment of its knowledge requirement in aiding and abetting cases will almost certainly have a tremendous nationwide impact. Any number of business entities may be subjected to potential liability for simply doing their jobs whenever their conduct is later second-guessed by plaintiffs. These entities would not even be able to rely on the state law duties governing their conduct as a guide to their potential liability. The new liability which will result from the court of appeals' permissive aiding and abetting standard cannot be justified given that the court of appeals' rule is inconsistent with *Ernst & Ernst v. Hochfelder,* this Court's leading mandate in this area of the law.

CONCLUSION

For the foregoing reasons, the Court should reverse the judgment of the Court of Appeals and reinstate the district court's ruling of summary judgment in favor of Central Bank.

Respectfully submitted this 30th day of July, 1993.

TUCKER K. TRAUTMAN
Counsel of Record for Petitioner
VAN AARON HUGHES
IRELAND, STAPLETON, PRYOR & PASCOE, P.C.
1675 Broadway, Suite 2600
Denver, Colorado 80202
Telephone: (303) 623-2700

Attorneys for Petitioner